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Legend

Coop =

State A =

Corp A =

Sub =

C =

Partnership =

Corp B =

LLC =

Company =

Investor =

Holding =

Corp D =

Corp E =

Inc =

b =

c =

Dear _____ :

This is in response to a request for rulings dated January 14, 2002, submitted on behalf of Coop concerning the proper treatment of the amount received from the sale of stock by Coop.

Coop was incorporated in b pursuant to the State A Rural Telephone Cooperative Act. According to Coop's articles of incorporation, Coop's stated purpose is to furnish telephone service to the largest practicable number of rural telephone users. Today, Coop provides directly and through its subsidiaries, a full range of telecommunications services, including wireline and cellular telephone, long distance and internet services, to c members in central and western State A.

Coop's bylaws state that any person or entity may qualify for membership in Coop by making an application, agreeing to purchase telephone services from Coop as a retail end user of such services, agreeing to comply with Coop's articles of incorporation and bylaws, and agreeing to pay the membership fee, if any, as established by the board of trustees. Currently, there is no membership fee, and every Coop wireline telephone customer is a member of the cooperative. As is the case generally with cooperatives, members are each entitled to one vote on matters submitted to a vote of the members.

The fundamental tenet of cooperative operation is that the profits of a cooperative are allocated and ultimately distributed to the cooperative's members based on the amount of business (patronage) ultimately done with the cooperative. The amount a cooperative member pays for the cooperative's products or services less the cost of providing such goods or services is allocated to the member. Thus, in theory, cooperative members receive the cooperative's products and services at cost. Of course, it would be impractical for a cooperative to return immediately all of its earnings to its members. Instead, like other corporations, cooperatives retain earnings in order to operate and expand. These retained earnings are treated as cash contributions to the capital of the cooperative and are credited to capital accounts kept for each member.

In general, Coop's board of trustees retains discretion as to how and when to redeem a member's capital. The board's current policy is to retire approximately 1% of member capital per year. The capital of deceased members is retired upon application by the deceased's estate and prior approval of the Coop board. In the event of liquidation or dissolution, after payment of all Coop's indebtedness, Coops members' capital credits would be retired on a pro rata basis.

Coop began in b with four exchanges and four part-time employees. Now, it employs more than _____ people to provide telephone service to over _____ residential customers and business in several non-contiguous service areas totaling approximately

square miles in central and western State A.

Despite Coop's increase in size, its service areas continue to be predominately rural, and its subscribers are widely dispersed. This is not unexpected. The Bell operation companies generally provide telephone service in larger metropolitan areas where such companies can generate sufficient economies of scale to justify their substantial investment in infrastructure. Historically, residents of rural areas generally had to fend for themselves in developing telephone services. They often did so by forming cooperatives, such as Coop to provide telephone service. Coop has approximately _____ subscribers per route mile; the average Bell telephone company, in comparison, has 130 subscribers per route mile. For this reason, the per-customer cost of building and maintaining wireline infrastructure is much higher for Coop than it is for larger telephone companies.

In the 1980s, the telephone industry began to change dramatically when cellular telephone technology became available. Recognizing the potential significance of wireless to its business, Coop moved quickly to build and operate an analog cellular network in its wireline territories. The new cellular technology was a potential blessing to both Coop and its member; simultaneously, it was a threat to Coop's core wireline business. For Coop's rural customers, who are frequently far away from wireline connections when they were driving in their cars or working on their farms, cellular telephone technology offered the possibility of convenient access to telephone service. For Coop, cellular technology suggested a way to serve more customers with less expansive infrastructure. However, a cellular network controlled by a Coop competitor could have threatened Coop's wireline network by taking customers from Coop and leaving it with a stranded investment in wireline infrastructure, i.e., an infrastructure with high fixed operating costs and insufficient users to generate necessary operating revenue. Therefore, in order to bring the latest and best telephone technology to its members and to protect its core wireline business, Coop settled on a policy of investing in new cellular technologies as they came along.

Pursuant to this strategy, Coop acquired FCC licenses and built a cellular network in its operating territory during the 1980s and early 1990s. Then, in _____, Coop expanded its service area by acquiring new territories in southwest State A from Corp A (the "Corp A Territories"). However, by the time Coop acquired these new wireline territories, other telecommunications companies had already acquired the available cellular licenses and had built and controlled the cellular network in those territories. Coop's lack of a cellular presence in these areas was a substantial source of concern, because a migration of Coop customers to the cellular services provided by competitors could have stranded Coop's investment in the Corp A Territories.

Wireless telephone continued to develop rapidly in the 1990s. New digital cellular technology that utilized a multiplexed signal promised to be the next big step, advancing wireless communications beyond the existing, analog wireless technology. One digital technology, known as code division multiple access ("CDMA"), promised

several advantages, including capacity increases of eight to ten times over analog wireless systems, improved call quality, simplified system planning, enhanced privacy, improved coverage characteristics, reduced power consumption (i.e., more talk time between battery changes in mobile units), and bandwidth on demand (crucial to the operation of wireless internet functions). But the government had to make new blocks of radio spectrum available for use before the new technology could be employed. In August 1993, President Clinton authorized the Federal Communications Commission to auction licenses for broadband personal communications services ("PCS). By March of 1995, the first of these auctions for 99 PCS licences had been completed. The new licences provided the auction winners with the necessary radio spectrum to begin providing advanced services (such as CDMA cellular communications) across the country.

The new PCS technology presented Coop with a problem that resembled the one presented by the initial introduction of analog wireless technology in the 1980s; new digital technology offered potential benefits to Coop's members but simultaneously threatened to bypass Coop's existing investment in its analog cellular business. As it had done in the 1980s, Coop again sought to confront the problem posed by the new technology by diversifying and providing new services. The new PCS technology offered a solution to the two problems for Coop; not only would diversifying into PCS enable Coop to hedge the possibility that its wireline and analog cellular systems would be bypassed by the new technology, it would allow Coop to acquire a wireless capacity in the Corp A Territories.

Unfortunately, the PCS license auction process did not favor small companies like Coop. Unlike the lottery process used in State A to allocate the radio spectrum that was utilized for analog cellular systems built in the 1980s, the PCS license auction process contained no provision to guarantee that some of the licenses would go to local wireline companies. In fact, the 1995 auctions were dominated by major, national companies including AT&T Wireless PCS, Inc. and Wireless Co., a partnership among Sprint, Tele-Communications, Inc., Cox Cable, and Comcast Telephony. Thus, when Coop decided that it was necessary to enter the PCS market it did not have the option of acting alone. To this day, AT&T Wireless and Sprint PCS effectively dominate the PCS market nationwide.

In _____, Coop, through its wholly owned subsidiary, Sub, entered into a Partnership with Corp B and LLC, in order to provide PCS service as a licensee of Sprint PCS. Coop contributed approximately \$ _____ million for a _____ % limited partnership interest. In _____ the Partnership entered into a management agreement with C Spectrum, L.P. and C Com, Inc. (the "C Agreement") with an initial term of _____ years. Under the C Agreement, the Partnership agreed to design, construct, and manage a PCS network (which used CDMA technology) and to pay _____ % of subscriber revenues to C. In return, the Partnership gained use of C's licensed spectrum and the C PCS brand name. At this point, Coop believed that it was making a long-term commitment to PCS.

In theory, PCS was supposed to save money for its operators. In practice, however, it proved to be very expensive to build. Effective coverage of a PCS cell required more radio towers than an analog wireless cell of the same size. In the capital demands of building the PCS network forced the Partnership to bring in new investors with deep pockets including Company and Investor. In the reorganized venture, Holding, Coop's interest was diluted to %. Despite the participation of Company, Holding was by 2000 again desperately short of capital. At one point, the managing member even had to apply for a personal line of credit to make payroll. Holding explored every possible option, including an initial public offering, to raise the necessary capital to continue to build and operate the PCS network by itself. Company refused to provide additional capital, and in fact imposed considerable pressure to divest. In the end, with capital gone, Coop had no choice but to bow to the will of Holding's larger investors and permit a sale of Holding.

As a result in the decision not to invest more capital in Holding, Holding began to search for a third-party acquirer. In , the corporate successor to Holding, Inc., was acquired by Corp E in a transaction structured to qualify as a reorganization pursuant to § 368(a)(2)(E) of the Internal Revenue Service Code of 1986. Sub received shares of Corp E in exchange for its Inc stock, valued at the time at approximately \$ million. Those shares are currently valued at approximately \$ million. Corp E is a holding company that operates as a group of entities which provide wireless PCS under the C brand name throughout the Southwest and Midwest.

Coop now proposes to cause Sub to contribute its operating assets to Corp D, an existing Coop subsidiary. Sub will then be liquidated, distributing the Corp E stock to Coop. Coop will sell the Corp E stock, and proceeds from the sale will be allocated to the capital accounts of Coop's members based on the balance of such patronage accounts accrued between 1998-2002, the years during which Coop was a partner in the Partnership, a member of Holding, or a stockholder of Inc or Corp E. In so doing, Coop will follow Treas. Reg. § 1.1382-3(c)(3), which specifies that capital gains from the sale of assets held for more than one year should be allocated "insofar as is practicable, to the persons who were patrons during the taxable years in which the assets was owned by the association in proportion to the amount of business done by such patrons during such taxable years."

Based on the information set forth herein, Coop requests the following ruling:

That the amount realized from Coop's sale of the Corp E stock constitutes "patronage-sourced" income.

Code § 501(c)(12) contemplates that rural cooperative telephone companies may qualify as tax-exempt organizations. As the telephone business has developed, however, very few rural telephone cooperatives now qualify for this exemption; Coop falls into this category, and thus is a non-profit, but taxable, cooperative corporation.

Subchapter T of the Code, §§ 1381-1388, provides the statutory scheme for

taxing most cooperatives. Rural telephone cooperatives, however, are not governed by subchapter T, because of the exclusion provided by Code § 1381(a)(2)(C) for rural telephone cooperatives. When Congress enacted subchapter T in 1962, Congress excluded rural telephone cooperatives in order to avoid over-regulating them and, presumably, to provide them with more flexible tax treatment because of the necessary services they provided to under-served parts of the country. The underlying committee reports stated that cooperative corporations engaged in providing telephone service to persons in rural areas would continue to be treated the same as under prior law. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 113, 310 (1962); see also, Rev. Rul. 83-135, 1983-2 C.B. 149.

Sections 1382 and 1388 of subchapter T placed new restrictions on the ability of cooperatives to deduct patronage dividends that were allocated but not paid; in many other ways, however, subchapter T codified the law that existed prior to 1962. Since its enactment in 1962, most of the development in the law regarding the taxation of cooperatives has occurred in cases under subchapter T. Thus while the cases and rulings interpreting subchapter T may not control the taxation of rural telephone cooperatives such as Coop, these authorities indicate the position of the Service and the courts on many of the issues that do control the taxation of rural telephone cooperatives.

Cooperatives are a unique form of business entity which are democratically controlled by their patrons. In cooperatives such as Coop, each member has one vote regardless of how much capital he or she contributed. Cooperatives are required to allocate their net margins from business done with or for their patrons back to such patrons in proportion to their patronage. This return of patronage-sourced income is bound up with the basic concept of a cooperative. Rather than using their net income to pay dividends to their shareholders, as a regular corporation would, cooperatives pay patronage dividends to their members based on the amount of business that the member does with the cooperative. Patronage dividends are thus effectively price rebates for member-patrons. See, CF Industries, Inc. v. Commissioner, 995 F.2d 101, 103(7th Cir. 1993).

The taxable income of a cooperative is calculated in much the same manner as the taxable income of a taxable corporation, with one distinct difference: the income of a cooperative that is attributable to business done with or for patrons is excluded from or deducted from the income of the cooperative when such income is allocated to the cooperative's patrons. At the time this "patronage-sourced" income is allocated or (in the case of cooperatives not subject to subchapter T) at the time it is distributed, the cooperative's patrons realize the income. Patronage-sourced income flows through the cooperative and is taxed only once.

In order for the amount realized from the proposed sale of the Corp E stock to be deductible to Coop upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Coop's patrons. While neither the Code nor the regulations provide a clear definition of "patronage-sourced income," the courts have, in general, held that "if the income at issue is produced by a

transaction which is directly related to the cooperative enterprise, such that the transaction facilitates the cooperative's marketing, purchasing or service activities, then the income is deemed to be patronage income." Farmland Industries, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106; Land O'Lakes, Inc. v. United States, 675 F.2d 988, 993; Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 243; Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459).

In Rev. Rul. 69-576, 1962-2 C.B. 166, the Service provided the following analysis of what it means for income to be patronage sourced:

The classification of an item of income as from either patronage or non-patronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the cooperative's operation, the income is from non-patronage sources.

See also, Rev. Rul. 74-160, 1974-1 C.B. 245 (ruling that interest income realized from loans made by the taxpayer was patronage source, because the loans "actually facilitated the accomplishment of taxpayer's cooperative activities, in that [the loans] enabled the taxpayer to obtain the necessary supplies for its operations.")

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced. In Farmland Industries, the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision the court stated that its task was to "determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons," 78 T.C.M. at 870.

Emphasizing the need "to focus on the 'totality of the circumstances' and to view the business environment to which the income producing transaction is related," the Tax Court analyzed the reasons behind both the organization of the subsidiaries and their eventual disposition, Id. at 864, 865. First, it looked at whether the taxpayer's subsidiaries were organized to perform functions related to its cooperative enterprises. The subsidiaries had been organized to explore for, produce, and transport crude oil. The court determined that all of the subsidiaries were organized to perform functions

related to the taxpayer's business and were not mere passive investments. Id. at 871.

In other cases, the direct relationship between the purpose of a cooperative business and its reasons for investing in a subsidiary were found to be dispositive on the question of whether income received from the subsidiary was patronage sourced. For example, in Astoria Plywood Corp. v. United States, 1979WL 1287 (D.Or.), the court found that the income derived by a plywood and veneer workers' cooperative from the cancellation of a lease on a veneer plant was patronage sourced, because the production of veneer was an integral part of the cooperative's business. In other words, the reason the cooperative leased the property to begin with had nothing to do with investing in real estate and everything to do with making veneer. Similarly, in Linnton Plywood Assoc. v. United States, 410 F.Supp. 1100 (D.Or. 1976), the court held that the dividends received by a plywood workers' cooperative from West Coast Adhesives, a glue supplier which the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income, since glue is essential for the manufacture of plywood, and the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

Coop's investment in the various wireless telephone entities was directly related to its cooperative business. Investing in a company in order to provide modern telephone services is directly related to the business of a cooperative whose *raison d'être* is to provide telephone service to its patrons.

In CF Industries, Judge Posner noted in his opinion that the court was "not aware of any dramatic opportunities for tax avoidance by use of the cooperative form." 995 F.2d at 104. However, the court implied that a cooperative would be gaining an unfair tax advantage for its members if it were investing in businesses unrelated to its cooperative purpose and in effect "running a mutual fund for its members on the side." Id. Judge Posner indicated that one type of transaction would not pass the "mutual fund" test: a temporary investment by a cooperative in securities. See id. Certainly, if Coop had taken its members' capital and purchased a diversified portfolio of public company securities, there can be no doubt that the proceeds from such a portfolio should not and would not be patronage sourced.

However, here Coop's decision to invest in Partnership was "directly related" to its cooperative business. Coop's articles of incorporation specifically provide that Coop's purpose is to furnish telephone service to the largest practicable number of rural telephone users. Coop's investment in Partnership had two objectives. First, it was trying to protect its existing business and its members; Coop believed that both would be adversely affected if telephone uses in its territories switched to wireless telephone (PCS) provided by someone other than Coop. Second, Coop sought to add wireless service in the Corp A territories where it previously could only offer wireline service. Coop's management and board of directors state unequivocally that the purpose of Coop's participation in Partnership was to facilitate the accomplishment of Coop's service goals and not to make a short-term profit investing in PCS.

Accordingly based solely on the above, we rule that the amount realized from Coop's sale of the Corp E stock constitutes "patronage-sourced" income.

This ruling is directed only to the taxpayers that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the power of attorney submitted with the ruling request, a copy of this letter is being sent to Coop.

Sincerely yours,
Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: